

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

It has been almost a decade since the first Islamic unit trust fund was established in Malaysia. Since then, we have witnessed an encouraging trend of growth of the sector. The emergence of Islamic unit trust in the Malaysian unit trust industry is another reflection of a strong desire and commitment of the Muslim community as well as the government in promoting financial products that is in compliance with the *syariah* principles.

Prior to that, in 1983, when the Islamic Banking Act was passed and followed by the establishment of the first bank that operate in compliance with the principle of *syariah* namely Bank Islam Malaysia Berhad (BIMB), the Islamic banking industry started to flourish rapidly as an alternative mode of fund mobilization and financing that is free from the conventional interest-based practices in Malaysia. In complement to the full-fledge Islamic banks, since 1993, the interest free banking scheme was introduced with all financial institutions started to offer Islamic banking windows parallel with their existing conventional operations. This development had brought about even further access of Islamic banking services to the public at large.

The banking sector, however, is only one component of the financial system; the capital market is the other. The strong tendency towards disintermediation in the financial market will soon spread to Islamic finance. Hence the Islamic banking sector must necessarily be complemented with, and augmented by, an Islamic capital market. Both need to co-exist symbiotically in order to offer issuers with efficient and acceptable modes of raising capital and investors with the choice of instruments acceptable to Islam.

Thus, the emergence of the Islamic unit trust sector in the Malaysian capital market is another series of continuous commitment by various parties in materializing a full fledged Islamic financial system that is in line with Islamic principles in Malaysia, which is as efficient and competitive as its conventional counterpart in serving the financial needs of the Malaysian community irrespective of their religious belief. The development of the Islamic unit trust in Malaysia will stimulate the breadth and depth of the Malaysian Islamic capital market. Growth in funds under management will promote more and more issuance of new securities that are in compliance to *syariah* in order to capture the available supply of funds. On top of that, it will attract financial players and issuers to comply their existing products with Islamic principles to gain access to such funds.

If we compare our achievement with other Muslim countries, the development of the Islamic unit trust sector in Malaysia is in the forefront. What we have achieved today is a reflection of the large amount of funds available in the hands of investors who are

looking for instruments and modes of investment that are acceptable to, and in compliance with, the *syariah*.

However, we should not quickly satisfy ourselves with what we have accomplished. In fact, in this context, after almost a decade of operation in the market, Islamic unit trust has only managed to capture a minuscule proportion of the overall unit trust industry in Malaysia. The journey had only started with million miles to go. Thus, to ensure its continued success, efforts must be taken to improve the competitiveness of the products as well as to provide investors with a variety of products that meet their needs.

This study tries to make an exploratory analysis and assessment of the Islamic unit trust industry in Malaysia for the past decade. The paper will analyse the development of the industry since its establishment with respect to its growth, performance, risk and return characteristics as well as the consistency of funds' performance over time. The findings of this research will give us a clearer picture of where the Islamic unit trust stands vis-à-vis the overall unit trust industry as well as in the context of the Islamic capital market in Malaysia. This enables us to have useful insights in understanding the sector and can be instrumental in mitigating whatever discrepancies if there may be as well as strengthening any weaknesses. It is hoped that the enduring commitment to improve the competitiveness and performance of Islamic financial products and in particular the Islamic unit trust in Malaysia will build up market confidence and bring them to the higher end of the mainstream financial system in Malaysia. In addition to that, a well-developed Islamic capital market combined with a

mature banking industry will give Malaysia a niche in the global Islamic financial arena and subsequently will emerge as the international Islamic financial centre

1.2 ISSUES PERTAINING TO ISLAMIC UNIT TRUST IN MALAYSIA

The Islamic unit trust scheme in Malaysia is a subset of the overall unit trust industry and a component of the Malaysian Islamic capital market. The industry is highly regulated by the authority concerned, the Securities Commission in order to protect the investors interest and to ensure the integrity and systemic stability of the industry are well kept. In Malaysia the level of awareness among investors in investing in unit trust is still low. Until June 30 2002 the Net Asset Value for overall industry is only about RM54 billion representing 10.64% of the Kuala Lumpur Stock Exchange (KLSE) market capitalization. Hence, as a whole, unit trust is not yet fully optimized as an efficient financial intermediary.

The Islamic unit trust has only started to operate in 1993, with the establishment of Tabung Ittikal Arab Malaysian managed by the Arab Malaysian Unit Trust Berhad. Since then we have witnessed an encouraging growth in the Islamic unit trust industry. However, the size of the fund is still very small compared to overall unit trust industry. As of June 30, 2002 there were 34 Islamic funds approved by the Securities Commission and 31 funds had been launched and operate in the market with a total net asset worth of about RM 2.9 billion. This figure represents only about 5.33 percent of

the total net asset value of the unit trust as a whole. Compared to the KLSE's market capitalization, it is only a minuscule 0.57 percent.

From the figures mentioned above, we can see that the Islamic unit trust is still lagging far behind conventional unit trust especially in terms of the size of funds. Such phenomenon is also prominent in banking sector in which the Islamic product is still in a marginal volume. Besides that, likewise other Islamic financial instruments, the Islamic unit trust industry is also highly dependent on Muslim community as well as government support.

In order to be acceptable by investors and financial players, the sector requires the existence of a market where investors looking for investment have confidence in the product and feel comfortable with a sufficient array of instruments that caters to their investment needs in a fairly comprehensive way. Apart from the choice of financial instruments, market intermediaries should be sufficiently skilled and well versed regarding the products on offer. Only then will the market be able to attract the interest and participation of issuers and investors, which in turn will promote the growth of financial services and motivate market intermediaries to be more innovative and competitive.

Besides that, continuous monitoring and assessment on existing products must also be taken to track their performance as well as identifying their weaknesses. Such evaluation is crucial in improving the competitiveness and performance of the instruments and hence will increase market confidence. Thus, the developmental

agenda requires the continuous commitment of various parties including issuers, investors, intermediaries and Islamic scholars who are confident in, and willing to use, the instruments and services offered to them as well as those who are committed to further developing the instruments and services.

In this context, we are very fortunate to have in place, three very important elements that support the agenda.

1. Full commitment of the government,
2. Interest and commitment of investors and issuers because of the success of the Islamic banking sector, and
3. An available pool of experts - industry participants and Islamic scholars who are willing to discuss and debate issues in a manner that would benefit the market.

We will have to build on these strengths. The ultimate goal is to have an Islamic financial product, and in this context particularly the Islamic unit trust, to be as competitive and innovative as its conventional counterpart. This can be realized by broadening and deepening the sector and built up market confidence by improving its viability and performance.

Hence, this study is dedicated to make an exploratory analysis and assessment of the Islamic unit trust sector in Malaysia after almost a decade of its operation. Findings from this research will be instrumental in improving any shortcomings of the product in order to become as viable, competitive and attractive as its conventional counterpart.

1.3 PURPOSE OF THE STUDY

The research objectives of this study are as follows;

- a) To assess the development and growth of the Islamic unit trust sector in Malaysia for the past decade since its establishment;
- b) To evaluate the performance of the Islamic trust funds in Malaysia, to rank their individual performances and to compare their performance against the market portfolio;
- c) To determine if the Islamic unit trust funds' risk and returns characteristics are consistent with their stated objectives;
- d) To evaluate the degree of risk diversification of the Islamic unit trust funds; and
- e) To evaluate the consistency of the investment performance of the Islamic unit trust funds over time.

1.4 SCOPE OF THE STUDY

This study is an exploratory assessment of the Islamic unit trust sector in Malaysia after almost a decade of operation. Thus, it will analyse the growth and development of the sector for the past decade in terms of several indicators such as the total number of fund approved, total size of fund approved, unit in circulation, number of accounts as well as the total assets of the funds. In addition to that, the study will also cover the performance of the Islamic unit trust funds since their inception until now, which is within the period of January 1993 to June 2002. However, only those funds

which have at least four years historical performance records are taken for the study. The period of almost a decade of operation in the market is sufficient enough to be assessed since it covers the various bulls and bears phases of the market in Malaysia. Therefore, the results and the analysis would provide a fairly objective assessment on the development and performance of the Islamic unit trust funds.

1.5 ORGANIZATION OF THE STUDY

This paper constitutes six chapters that discuss salient features of the study from the background of the field to its research finding and its implications. Chapter 1 acts as an introduction of the study and illustrates the research background, issues related to this study, its objectives, scope and the organization of this paper.

Chapter 2 briefly explains the background, development and other related issues pertaining to the Islamic unit trust vis-à-vis the overall unit trust industry. This chapter also briefly touches on some of the concepts and practices of the unit trust industry in Malaysia, the *syariah* principles related to Islamic unit trust as well as the roles and responsibilities of the authorities and committees concerned in regulating and developing the industry.

Chapter three describes the past studies with regard to this topic available in the literature. It includes early empirical studies in the area and the performance evaluation techniques, studies done in the West, recent studies made in the region including

Malaysia, as well as those made specifically on Islamic unit trust performance in Malaysia.

Chapter four explains the research methodology that will be adopted through out this study. This chapter describes the sources of data, fund selection techniques, and data analysis techniques in the study.

Chapter five discusses the research findings based on the techniques outline in the previous chapter. The first section will analyse the growth and development of the Islamic unit trust sector in Malaysia based on several indicators. Some analysis of the industry in the global arena is also briefly described. The second section analyses the performance of Islamic unit trust fund measured by different benchmarks, compliance of fund stated objective, its degree of risk diversification as well as its consistency of performance over time.

The last chapter, chapter six concludes the paper with a summary of the study and the implications raised by the findings. The findings might be useful in strengthening the performance, competitiveness, consistency and public confidence of the product. Finally, the chapter ends with some discussion on the challenges and prospects of the sector along with some considerations and recommendations.